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April 30, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (Regulation YY; Docket No. 1438; RIN 7100-AD-86)

Dear Sir or Madam:

The Independent Community Bankers of America¹ (ICBA) welcomes the opportunity to comment on proposed rules that would implement the enhanced prudential standards required to be established under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the early remediation requirements established under section 166 of the Dodd-Frank Act. The enhanced standards include risk-based capital and leverage requirements, liquidity standards, requirements for overall risk management, single-counterparty credit limits, stress test requirements, and a debt-to-equity limit for companies that the Financial Stability Oversight Council (FSOC) has determined pose a grave threat to financial stability. The early remediation requirements establish measures of financial condition and remediation requirements that increase in stringency as the financial condition of a covered company declines.

ICBA's General Comments

ICBA agrees with the Federal Reserve that the recent financial crisis showed that many of the large banking firms were so large, leveraged, and interconnected that their failure posed a substantial threat to the overall financial stability of the United States. The crisis demonstrated weaknesses not only at the large financial companies but also in the existing framework for supervising and regulating them and in the ability of the government to manage the failure of so many financial companies.

¹ *The Independent Community Bankers of America®*, the nation's voice for more than 7,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services. For more information, visit www.icba.org.

The resulting unprecedented intervention by the government to reduce the impact of, or prevent, the failure of these companies cemented the market perception that many of these companies are “too-big-to-fail.” This market perception that there are financial companies that are “too-big-to-fail” poses significant threats to our financial system. Not only does it reduce the incentives of shareholders, creditors and counterparties of these companies to discipline excessive risk-taking, but, more importantly to community banks, it allows these companies to operate with a significant funding advantage. **This distortion is unfair to community banks, damaging to competition, and encourages further consolidation and concentration in the financial system.**

Furthermore, the problem has only gotten worse since the beginning of the financial crisis in 2008. The banking industry is now more concentrated than it has ever been, with half of the industry’s assets now in the hands of five institutions with combined assets that equate to 58% of the nation’s gross domestic product (GDP). The combined assets of the ten largest depository institutions equate to 65% of the banking industry’s assets and 75% of this nation’s GDP.

ICBA strongly supports enhanced capital and liquidity requirements and single-counterparty limits for bank holding companies with total consolidated assets of \$50 billion or more and nonbank financial companies that have been designated by FSOC as systemically important (SIFIs). We also strongly support a significant capital surcharge on SIFIs that would not be less than what was proposed by the Basel Committee for G-SIFIs—a progressive common equity tier 1 capital requirement of between 1% to 2.5%, depending on the bank’s systemic importance.

Enhanced supervision of the SIFIs together with a significant capital surcharge will provide more stability to our financial system and discourage SIFIs from becoming larger and more interconnected. It will also mitigate to some extent the funding advantage that SIFIs have over community banks.

We note that the Federal Reserve intends to propose as a “second stage” to this proposal a quantitative risk-based capital surcharge in the United States based on the Basel Committee’s approach and consistent with the BCBS’s implementation timeframe. ICBA looks forward to the Federal Reserve’s proposal later this year and hopes that it will be implemented not later than 2014. **Community banks do not want to see a repeat of the 2008 financial meltdown when our largest banks were bailed out at taxpayer’s expense largely because they were undercapitalized, overleveraged and engaging in risky activities that put our entire economic system at risk.**

ICBA’s Specific Comments Concerning the Proposal

Capital Requirements. Section 165 of the Dodd-Frank Act directs the Federal Reserve to establish risk-based capital and leverage standards for SIFIs that are more stringent than the risk-based capital and leverage standards applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States. The Federal Reserve proposal would require SIFIs to submit board-approved annual capital plans to the Federal Reserve in which they

demonstrate their ability to maintain capital above the Federal Reserve's minimum risk-based capital ratios (total capital ratio of 8 percent, tier 1 capital ratio of 4 percent) and tier 1 leverage ratio (4 percent) under both baseline and stressed conditions over a minimum nine-quarter, forward-looking planning horizon. In addition, these bank holding companies must demonstrate the ability to maintain a minimum tier 1 common risk-based capital ratio of 5 percent over the same planning horizon under both baseline and stress conditions.

ICBA believes that Federal Reserve should focus more on the tier 1 leverage ratio and less on risk-based capital when applying capital standards for SIFIs. We agree with the comments of former FDIC Chairman Sheila Bair concerning the recent stress test on the large bank holding companies when she criticized that test because it focused too much on risk-based capital ratios and not on leverage ratios. During the recent financial crisis, the market was always extremely skeptical about a large bank's risk-adjusted capital ratios because of the concern that such ratios do not accurately represent an entity's loss-absorbing capital. In the middle of a financial crisis, market perception is important, and the market will only perceive tier 1 capital as real capital for a SIFI and will discount risk-based capital ratios.

Along with the requirement that SIFIs maintain a total risk-based capital ratio of 8% and a tier 1 common risk-based capital ratio of 5 percent, ICBA recommends that SIFIs also maintain a tier 1 leverage ratio significantly higher than 4% under both baseline and stressed conditions. We recommend at least 6% tier 1 leverage ratio for SIFIs to ensure that they have sufficient tangible capital to absorb the types of losses that occur during a financial crisis and that the market perceives them as sufficiently capitalized. As we have noted above, ICBA supports a significant capital surcharge on SIFIs and that surcharge would help an institution maintain its leverage ratio high enough to withstand another crisis like the credit crunch of 2008.

Liquidity Requirements. ICBA agrees with the Federal Reserve that many large financial companies experienced significant financial stress because they did not manage their liquidity in a prudent manner. In many cases, the difficulties experienced were due to lapses in basic principles of liquidity risk management. In particular, the firms' inappropriate reliance on short-term sources of funding such as the repo market was a key factor in the liquidity crises many firms faced.

ICBA believes that the SIFIs should be subject to enhanced liquidity requirements and fully supports the Federal Reserve's liquidity proposal. The proposed rules would introduce liquidity stress testing requirements for covered companies and require covered companies to continuously maintain a liquidity buffer of unencumbered highly liquid assets sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios. The proposed rules would also require a covered company to generate comprehensive cash flow projections, to establish and monitor its liquidity risk tolerance, and maintain contingency plans for funding.

As we discussed about the SIFI surcharge, ICBA looks forward to the “second stage” of the Federal Reserve’s proposal which would require SIFIs not only to hold additional capital but satisfy specific quantitative liquidity requirements based on the Basel III proposal. The future proposal limits would be based on Basel’s work surrounding the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). **We look forward to a specific proposal later this year with an implementation no later than 2014.**

Single-Counterparty Exposure Limits. During the recent financial crisis, the effect of one large financial institution’s failure was amplified by the interconnectedness of large, too-big-to-fail firms and the degree to which they extended each other credit and served as over-the-counter derivative counterparties to each other. Counterparties of a failing firm were strained when the failing firm could not meet its financial obligations resulting in the counterparties’ inability to meet their own obligations. Furthermore, while banks were subject to single-borrower lending and investment limits, these limits were applied at the bank level, rather than holding company level, and excluded credit exposures generated by derivatives and in some instances, repos.

ICBA strongly supports the establishment of single-counterparty credit concentration limits for SIFIs in order to limit the risks that the failure of any individual SIFI could pose to other companies. The Dodd-Frank Act directs the Federal Reserve to prescribe regulations that prohibit SIFIs from having credit exposure to any unaffiliated company that exceeds 25% of the capital stock and surplus of the covered company. It also authorizes the Fed to lower the 25% threshold if necessary to mitigate the risks to the financial stability of the United States.

Under the Federal Reserve’s proposal, there would be a general limit that would prohibit any SIFI from having aggregate net credit exposure to any single unaffiliated counterparty in excess of 25% of the SIFI’s capital stock and surplus. In addition, the rule would establish a more stringent net credit exposure limit of 10% between a “major covered company” and any “major counterparty.” The proposal would define a “major covered company” as any nonbank covered company or any bank holding company with total consolidated assets of \$500 billion or more and a “major counterparty” as a “major covered company.” Both the general and more stringent credit limits would be measured in terms of a covered company’s capital stock and surplus.

ICBA fully supports the Federal Reserve’s proposal on single-counterparty exposure limits and in particular, those higher requirements on a “major covered company.” We agree with the proposal’s definition of a “major covered company” but recommend that the proposal include gross limits on credit and not simply rely on aggregate net credit exposure. Using gross limits will reduce the opportunity for institutions to lower their counterparty exposure levels through exemptions. The counterparty limits should be clear and concise and not subject to numerous exemptions that might allow a SIFI to avoid the requirements.

Debt-to-Equity Limits for SIFIs. The Dodd Frank Act requires a covered company to maintain a debt-to-equity ratio of no more than 15-to-1, upon a determination by the

FSOC that such company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk such company would pose to the financial stability of the United States. The Federal Reserve proposes that once FSOC has determined a company poses a grave threat, they would receive a written notice from the Federal Reserve and would have a 180 day period to comply with the 15-to-1 debt-to-equity ratio requirement.

ICBA recommends that the regulations also address what it means to “pose a grave threat to the financial stability of the United States.” The Dodd-Frank Act mentions some of the criteria that FSOC should consider including the leverage of the company, and the company’s scope, size, scale, concentration and interconnectedness. However, the statutory criteria is still too vague and needs to be clarified to establish a more workable process. Furthermore, the 180-day compliance period needs to be shortened to no longer than 120 days. If a company indeed poses a grave threat to the financial system, the company should be make changes more expeditiously than 180 days.

Early Remediation Requirements. ICBA endorses the Federal Reserve’s proposed regime for the early remediation of financial distress at covered companies. The proposal includes four levels of remediation including (1) heightened supervisory review, (2) initial remediation, (3) recovery, and (4) recommended resolution. While the proposed framework includes regulatory capital triggers, non-discretionary restrictions on growth and capital distributions would occur once a covered company’s capital levels fall below the “well capitalized” threshold. In contrast, similar actions do not occur under the FDIC’s Prompt Correction Action or PCA regime until a depository institution falls below the “adequately capitalized” level. In addition to regulatory capital-based triggers, the proposed rule includes forward-looking triggers based on (1) stress tests, and (2) market indicators.

As we mentioned above, we believe the Federal Reserve should focus more on the leverage ratio than on risk-based capital ratios. **Therefore, we would recommend imposing Level 2 restrictions when a SIFI’s capital falls below a 6% tier 1 leverage ratio. Furthermore, we would impose more stringent restrictions on dividends and other capital distributions at Level 2.** For instance, at Level 2, we would recommend restricting the dividends to no more than 30% of the average of the coverage company’s net income in the previous two quarters rather than the proposed 50%.

Stress Tests. As we stated in our letter to the OCC and the FDIC on stress testing, **ICBA agrees with the banking agencies on the importance of stress testing for the largest banking organizations.** The 2007-2009 financial crisis underscored the need for large banking organizations to incorporate stress testing into their risk management practices, as many of these organizations were not adequately prepared for the stressful events that followed the September 2008 bankruptcy of Lehman Brothers when the financial markets became completely dysfunctional. Stress testing will provide forward-looking information to assist the regulators in their overall assessment of a large bank’s capital adequacy, helping to better identify potential downside risks and the potential impact of adverse outcomes on the large bank’s capital adequacy, and to assist it in ensuring the institution’s financial stability.

The Federal Reserve's stress test proposal would cover any state member bank, bank holding company or savings and loan holding company with more than \$10 billion in total consolidated assets. Under the proposed rules, covered institutions would be required to conduct annual stress tests using the institution's financial data as of September 30th of that year to assess the potential impact of different scenarios on the consolidated earnings and capital of that institution and certain related items over a nine-quarter forward-looking planning horizon. The proposed rules would require each covered institution to use a minimum of three sets of economic and financial conditions, including baseline, adverse, and severely adverse scenarios.

As we stated in our letter to the OCC and the FDIC, it is critical that the agencies coordinate the development of the annual stress test scenarios on an interagency basis to ensure consistent and comparable stress testing for all covered financial institutions and to minimize regulatory burden. For most institutions with between \$10 billion and \$50 billion in assets, we would suggest that the scenarios just address general macroeconomic factors. Institutions that are more complex or that have significant trading positions should incorporate rate "shocks" into their stress tests.

ICBA also commends the banking agencies for not requiring annual, comprehensive stress testing for institutions with consolidated assets of \$10 billion or under.

Although many community banks already stress test their loans and their investment portfolios for interest and credit rate risks and the adequacy of their capital, they do not engage in the type of extensive and continuous stress testing that is contemplated by the current proposals. **To require community banks to annually stress test based on complicated economic and financial scenarios would be both costly and burdensome.** Stress testing should be confined to those complex large organizations with material risk exposures to the banking system through derivatives and other types of products, and substantial on and off balance sheet items that are vulnerable to sudden changes in the market.

Conclusion

ICBA strongly supports enhanced capital and liquidity requirements and single-counterparty limits for SIFIs and we also strongly support a significant capital surcharge on SIFIs that would not be less than what was proposed by the Basel Committee for G-SIFIs—a progressive common equity tier 1 capital requirement of between 1% to 2.5%, depending on the bank's systemic importance. Enhanced supervision of the SIFIs together with a significant capital surcharge will provide more stability to our financial system, discourage SIFIs from becoming larger and more interconnected, and mitigate to some extent their funding advantage over community banks. We look forward to reviewing the "second stage" proposal later this year that would spell out a SIFI capital surcharge and higher quantitative liquidity requirements for SIFIs.

With regard to the requirement that SIFIs submit board-approved annual capital plans to the Federal Reserve, we recommend a stronger focus on the tier 1 leverage ratio and less on risk-based capital ratios. ICBA recommends that SIFIs maintain a tier 1 leverage ratio

of 6% under both baseline and stressed conditions. This would ensure that they have sufficient tangible capital to absorb the types of losses that occur during a financial crisis and that the market perceives them as sufficiently capitalized.

ICBA fully supports the Federal Reserve's liquidity and single-counterparty credit concentration limits. The proposal should also include gross limits on credit and not simply rely on aggregate net credit exposure since this will limit the opportunity for institutions to game the system and lower their counterparty exposure levels through exemptions.

With respect to the debt-to-equity limits on SIFIs, ICBA recommends that the proposal address what it means to "pose a grave threat to the financial stability of the United States." Furthermore, the 180-day compliance period should be shortened to no longer than 120 days. ICBA endorses the Federal Reserve's proposed regime for the early remediation of financial distress at covered companies but recommends imposing Level 2 restrictions when a SIFI's capital falls below a 6% tier 1 leverage ratio. We also recommend imposing more stringent restrictions on dividends and other capital distributions for Level 2 covered companies.

ICBA agrees with the Federal Reserve on the importance of stress testing for the largest banking organizations. However, it is critical that the banking agencies coordinate the development of the annual stress test scenarios on an interagency basis to ensure consistent and comparable stress testing for all large financial institutions and to minimize regulatory burden. Differences between the proposals should be resolved so that the tests are implemented consistently.

ICBA commends the regulatory agencies for not requiring stress testing for institutions with consolidated assets of \$10 billion or under. For the large banks, stress testing would have been helpful during the 2007-2009 financial crisis in identifying those institutions that were overexposed to derivatives and to subprime mortgages. However, for most community banks, the regulatory burden and cost of annual stress tests would substantially outweigh the benefits.

ICBA appreciates the opportunity to comment on the Federal Reserve's proposed rules that would implement the enhanced prudential standards required to be established under section 165 of the Dodd-Frank Act and the early remediation requirements established under section 166 of the Act. If you have any questions about our letter, please do not hesitate to contact me at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,
/s/ Christopher Cole

Christopher Cole
Senior Vice President and Senior Regulatory Counsel